Plus, Teleport responded immediately with a similar service guarantee for its competing services. Because Teleport was permitted to file its tariff on only one day's notice, while NYNEX had to wait 45 days for its filing to become effective, Teleport's guarantee became effective before NYNEX's. In this instance, the existing regulatory process produced the anomalous result of permitting a competitor to obtain the marketing advantage occasioned by NYNEX's innovation. This is a clear case of how asymmetrical regulation fails to reward LECs for innovation and will, over the long term, stifle such innovation.

The current notice period is longer than necessary to reasonably allow for intervention by other parties, and prevents LEC customers from receiving new services as quickly as possible.[42] While a longer notice period may be necessary for a limited number of mandated new services, a general 45 day requirement penalizes LECs and their customers when applied to other types of new services which require less scrutiny. NYNEX believes that for non-mandated new services which remain subject to price cap regulation, 14 days' notice should be sufficient to allow for review by the Commission and other parties. For those services which the Commission deems sufficiently competitive to be removed from price cap

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42 Indeed, the lengthy notice period gives NYNEX's competitors the ability to use the regulatory process to delay NYNEX offerings.

regulation, LECs should be subject to the same notice requirements as their competitors.[43]

Several parties argue that the current rules governing costs used in the pricing of new services are too vague.[44] ICA, MCI and MFS propose that the floor cost requirement for pricing new services be specified as Total Service Long Run Incremental Costs ("TS-LRIC"). WilTel would require uniform overhead loadings on all new services, with no variation allowed across all price cap services.[45] MFS would require overhead distribution based on a price/cost ratio of all trunking services allowing a 10% variation from the average of all trunking services for any individual new service.[46] The proposals of WilTel and MFS would not only alter new services pricing, but would require revision of existing service rates.

These proposals would not further the goals of efficiency and simplicity, and would delay the introduction of new services. WilTel's proposal amounts to rigid prescriptive pricing -- a reimposition of cost-based, rate of return regulation. Moreover, both WilTel's and MFS' proposals would

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43 The Commission's current rules permit the LECs' competitors to file tariffs on one days' notice.

44 See ICA, MCI, MFS, WilTel.

45 WilTel at pp. 31-32.

46 MFS at pp. 17-18, 27.

improperly require the resetting of existing rates based on those parties' arbitrary apportionment of costs.[47]

ICA states that costs are difficult for regulators to verify, and therefore suggests an alternate approach to pricing new services that is not based on cost showings.[48] ICA recommends that new services should be incorporated into a surrogate new services basket that parallels each existing basket. Changes in the surrogate price index would be linked to and affect the primary price index whenever the surrogate index drops more than two percentage points below the current API for the basket. According to ICA, this "price linking" approach will remove the need for cost support for new services, and remove alleged LEC incentives to set low prices for new services in order to reduce the API when the services are brought into the basket and raise margins on less competitive services.

While NYNEX agrees there is a need to eliminate required cost showings and to increase pricing flexibility, the ICA proposal is faulty in several respects. First, ICA incorrectly assumes that the API changes when a new service is incorporated into price caps. In the price cap system adopted by the Commission, however, when a new service is introduced

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47 The Commission should reject proposals to mandate the use of TS-LRIC as the direct cost definition for new services. TS-LRIC, as described by proponents, is inconsistent with the current average variable cost standard as the pricing floor for existing and new services under price caps, which standard is also used to evaluate claims of predatory pricing under antitrust law.

48 ICA at p. 21, Attachment B.

into the basket and index, only the revenue weights associated with each rate are recalculated; the API stays the same.[49] The new service price can only affect other rates through a rate change going forward, and even then only in proportion to the new service's base period revenues. The base period revenues for most new services are generally a small percentage of total base period revenues. Since ICA's assumption that the API changes when a new service is incorporated is incorrect, the assertion that LECs can use low new service prices to increase other prices later is also incorrect. Second, although the ICA proposal removes the need for cost estimates, it still requires, and heavily depends on, uncertain demand projections for both the new service and existing cross-elastic services. Third, ICA's proposal does not resolve the basic issue of new services pricing, i.e. the reasonableness of the rate when the new service is introduced. A new services basket index could only regulate changes in the new service after the initial rate is set.[50]

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49 This characteristic of the price cap system is illustrated in AT&T's Petition for Waiver of the new services rules, filed on May 17, 1994, for its "Simple Savings Volume Discount Plan". If the service were incorporated into price caps as a "restructure" as AT&T had first requested, the API would have been affected. However, if treated as a "new" service, as the Commission required, the API is unaffected.

50 MCI also expresses concern about the potential interaction of new service prices and existing service prices if LECs are given "unfettered flexibility" over new services pricing. (MCI at p. 53.) MCI's argument, however, is the opposite of ICA's. MCI suggests that LECs have an incentive to introduce new services at rates much higher (rather than lower, as argued by ICA) than costs so that

(Footnote Continued On Next Page)

In an alternative proposal, MFS proposes that new services be incorporated immediately into price caps.[51] This suggestion suffers shortcomings similar to those of the ICA proposal. That is, the new services have no base period demand, a critical requirement for meaningful incorporation of a service into price cap indexes. In fact, this is the very reason the Commission left new services out of the indexes until some base period demand could be established. Absent base period demand, projected demand would have to be used to provide the revenue weight for the new service price. However, this would result in an index that is a mix of actual and projected demand, and would introduce uncertainty and controversy into the indexing process.

MFS also contends that LECs use new services pricing rules to reprice existing services, with the intention of lowering prices for those services in order to stifle competition.[52] To illustrate its argument, MFS mistakenly cites NYNEX Enterprise Services. However, NYNEX Enterprise is not a repriced existing service, as NYNEX Enterprise includes

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50 (Footnote Continued From Previous Page)

when they are incorporated into price caps, LECs can make "offsetting price changes", i.e. lower those rates and raise rates for other services. MCI is incorrect. MCI provides no valid basis for attributing an incentive to LECs to lower prices of new services when incorporated into price caps. The mere regulatory event of incorporation into price caps will not change the appropriateness of new services prices in the market. The "problem" which MCI described would not exist.

51 MFS at p. 26.

52 Id. at p. 23.

features and operating characteristics distinct from other tariffed services. Indeed, in resolving a challenge to NYNEX's tariff, the Commission held that petitioners had offered no compelling argument that NYNEX Enterprise Services were "like" services, i.e. that they were functionally equivalent to currently tariffed services.[53]

Although incorrect in their conclusions and solutions, the comments by ICA, MCI, MFS and WilTel are instructive in two respects. First, they demonstrate the need for a pricing relationship between new services which must be priced based on one set of rules, and existing services, which must be priced using different basket and band regulations. Second, MFS' and WilTel's focus on trunking services, and MFS' and ICA's contention that LECs use new services rules to lower prices for existing services, serve as evidence of competition for these services. Together, these points indicate the need for revisions to the new services pricing rules to allow LECs to relate the prices they set for new services to the prices of existing services and to those of competitors' services. This can be accomplished simply by removing the current ceiling restrictions from the price cap new services rules.

For all but a limited set of new services (e.g., Commission-mandated services), only a price floor restriction based upon average variable costs is warranted. For services that are competitive and/or are cross-elastic with existing LEC

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53 NYNEX Transmittal Nos. 180, 211, Order by FCC Common Carrier Bureau released July 16, 1993.

services, LECs do not have an incentive to overprice new services and must be allowed to set prices that reflect market conditions. For truly new services, LECs must be allowed to price at a level that rewards them for innovation and that covers the special risks and costs involved. In this way, the Commission can meet its goals of encouraging the introduction of new and innovative services in the public interest while ensuring reasonable rates consistent with a competitive market.

V. THE ARGUMENTS FOR RETENTION OF THE SHARING AND LOW-END ADJUSTMENT MECHANISMS ARE WITHOUT MERIT

NYNEX, and others, demonstrated that the time has come to eliminate the sharing and low-end adjustment mechanisms.[54] The sharing and low-end adjustment mechanisms are vestiges of rate of return regulation which seriously lessen efficiency and investment incentives. As one party correctly observed, the price cap "system is ... compromised to a considerable degree by the sharing mechanism."[55] Elimination of the sharing mechanism is also critical as a matter of regulatory parity. None of the LECs' competitors - IXCs, CAPs or cable companies - are subject to sharing requirements. The sharing mechanism should be eliminated so that the efficiency and investment incentives of the price cap plan are maximized. Several parties, however, argue that both

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54 See NYNEX at pp. 27-32; Rochester at pp. 12-13; US West at pp. 42-44; USTA at pp. 45-52.

55 CCIA at p. 7. See also Citizens for a Sound Economy Foundation at pp. 5-6.

the sharing and low-end adjustment mechanisms should be retained. Others argue that only the low-end adjustment mechanism should be eliminated. These parties are incorrect, and their arguments should be rejected by the Commission.

Those who argue for retention of the sharing mechanism generally claim that sharing is necessary to protect ratepayers from unreasonable rates and cross-subsidization of competitive services, and as a backstop against potential errors in the productivity offset.[56] Any concern that the sharing mechanism is necessary to protect customers from unreasonable rates is clearly unfounded. Price cap regulation, unlike the rate of return regulation that it replaced, assures that prices will remain reasonable through a formula that places strict limits on upward price changes, and includes an aggressive productivity hurdle that price cap LECs must meet.

The argument that the sharing mechanism must be retained as a "backstop" for errors in the productivity factor which would permit LECs to achieve excessive profits, is also without merit. The error of this argument is clearly demonstrated by actual LEC earnings results under the Commission's price cap regime. The LECs' earnings during the price cap period have been reasonable, and are comparable to those achieved by the Standard & Poors 400 companies.[57]

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56 AT&T at pp. 29-30; MCI at pp. 31-32; ICA at p. 14; WilTel at pp. 25-26; Ad Hoc at p. 24.

57 It is also important to note that the price cap LECs' earnings are lower than those achieved by AT&T, which is subject to a price cap plan that contains no sharing mechanism.

Thus, the LECs' earnings performance under price caps demonstrates that the productivity factor has not permitted, and will not permit, the LECs to achieve excess profits.

The Commission should also reject the arguments of those parties that would eliminate the low-end adjustment mechanism, while retaining the sharing mechanism.[58] The sharing and low-end adjustment was designed as a symmetrical mechanism in order to provide a balance of potential risks and rewards. As Professor Harris correctly observed, "[t]he worst possible risks-reward function, from the investors' perspective, would be sharing or capping profits upward, but leaving shareholders at risk in the downward direction."[59] Furthermore, elimination of only the low-end adjustment will not improve the incentive structure of the price cap plan. It will, in fact, provide additional disincentives by making risky investment even less attractive, while encouraging investment in unregulated businesses for which the return is not limited by the sharing mechanism. Both the sharing and low-end adjustment mechanisms should be eliminated in order to "stimulate the best possible performance from managers and employees and to attract sufficient capital to modernize and further expand the telecommunications infrastructure."[60]

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58 See AT&T at pp. 34-38.

59 Harris Study at p. 19 n.17.

60 Id. at p. 20.

Finally, several parties argue that NYNEX has misused the low-end adjustment.[61] In particular, AT&T and MCI argue that NYNEX did not follow the price cap rules in adjusting for the rate of return which fell below 10.25% in 1991, which resulted from a one-time charge for certain downsizing expenses. The Commission has already correctly rejected the arguments advanced by AT&T and MCI; it should not give them any further consideration in this proceeding.[62]

VI. THE PARTIES HAVE FAILED TO JUSTIFY AN INCREASE IN THE PRODUCTIVITY FACTOR

In its comments, NYNEX demonstrated that, based on projections of the long-term productivity of the LEC industry, the price cap formula's productivity formula should be reduced.[63] NYNEX also demonstrated that the 0.5 percent consumer productivity dividend included in the calculation of the productivity factor is unnecessary and should be eliminated.[64]

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61 AT&T at p. 36; MCI at pp. 32-33.

62 See In the Matter of 1992 Annual Access Tariff Filings, CC Docket No. 92-141, Memorandum Opinion and Order Suspending Rates and Designating Issues for Investigation, released June 22, 1992, at para. 13. ("We find NYNEX's justification -- to avoid the significant increase in the price cap index for this year followed by a comparably significant decreased in the index next year -- to be persuasive. By shifting these expenses into 1992 and 1993, NYNEX forgoes a major increase in its price cap index which would enable it to significantly increase prices.")

63 See NYNEX at pp. 35-41.

64 Id. at p. 40.

In contrast, several parties argue that the Commission should require a further reduction in access prices either through a one-time reduction in the Price Cap Index ("PCI"), adoption of a higher productivity offset, or both. A number of theories are used to support these arguments. Some parties argue that because LEC earnings, in some cases, exceeded 11.25% during the price cap period, the initial productivity offset was too low. Ad Hoc submits a report contending that LEC productivity has exceeded 3.3 percent, and that the productivity offset should therefore be increased. Others argue that the Commission should adopt the higher productivity factor that has been used in various intrastate price cap plans, while some claim that the productivity factor should be increased to account for anticipated future productivity growth. One party argues that the Commission should exclude the 1984 data point in calculating the productivity factor. Finally, Ad Hoc argues that the current 0.5% consumer productivity dividend should be increased to 1.0%. These arguments are all without merit and should be rejected by the Commission.

First, the argument that LEC earnings can be used to infer that the initial productivity factor was too low is incorrect.[65] In particular, short-term earnings, such as those observed since the start of price caps, are not a measure of long term total factor productivity ("TFP") which is the

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65 See AT&T, GSA.

only appropriate measure of LEC productivity.[66] Moreover, earnings are based on accounting costs, not economic costs which are reflected in the productivity factor. This difference can result in a substantial disparity between earnings and true productivity.[67]

The use of only three years of earnings results can never predict long-term productivity.[68] As Professor Harris notes, "productivity gains fluctuate widely in the short run.... [H]ence, one should not draw any inference about long term changes in productivity from short run experience."[69] Productivity must be measured over a sufficiently long period of time - 8 to 10 years - so that short-term fluctuations related to expansions and contractions of the business cycle, and other short-term phenomena, do not have a disproportionate impact on results. Furthermore, a productivity offset increase based on three years of earnings results would simply recapture any productivity gains achieved by LECs over the price cap period. This would seriously limit the incentives of price cap regulation. As NERA correctly observes, efficiency gains from price caps "depend on managers having confidence that superior

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66 See NYNEX at pp. 35-38.

67 See Comments of National Economic Research Associates Inc., June 1994, at pp. 31-35. ("NERA Reply"). The NERA Reply, in which NYNEX concurs, is attached to the reply comments submitted by USTA in this proceeding.

68 AT&T at pp. 23-24.

69 Report of Professor Robert G. Harris, Law & Economics Consulting Group, Inc., June 1994 at p. 27 ("Harris Reply Report"). The Harris Reply Report is attached to USTA's reply comments. See also NERA Reply at p. 7.

cost savings will not ultimately be taken away through inappropriate adjustments to the plan."[70] An increase in the productivity offset based on short term earnings would dampen efficiency incentives, and would constitute a step back toward rate of return regulation.[71]

Ad Hoc submits a study purporting to show that the productivity offset should be raised to at least 5.8 percent.[72] The ETI Study suffers from several serious infirmities. First, contrary to its claim, the ETI Study is not based on a study of nationwide TFP. Rather, it is based on estimates from only seven states representing only about one-third of the nation's population.[73] Use of such a limited universe in determining a LEC productivity factor is inappropriate.[74]

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70 NERA Reply at p. 35.

71 "In order to ensure long-term stability and to avoid a return to traditional regulation, it is absolutely essential that productivity levels realized under price caps not be used to recalculate the price caps productivity target." (NERA Reply at pp. 35-36.)

72 "LEC Price Cap Regulation: Fixing the Problems and Fulfilling the Promise", Economics and Technology, Inc., May, 1994 ("ETI Study").

73 These states are California, New York, Pennsylvania, Delaware, Illinois, Indiana and Ohio. Moreover, the territories of three RBOCs, US West, BellSouth and Southwestern Bell are entirely excluded from Ad Hoc's study.

74 Furthermore, the ETI Study contains a transcription error that inflates the TFP for the seven states used by ETI. The correct TFP for Delaware is 3.5%, rather than 5.4%, which reduces the average from 3.8% to 3.5%.

ETI also argues that the current productivity offset is based on incorrect assumptions and that, as a result, the current productivity offset is seriously understated. Specifically, ETI argues that the productivity offset was based on an assumption that the rate of change of LEC input prices is equal to the rate of change of input prices for all firms in the U.S. economy.[75] ETI is incorrect.

It was never assumed that input prices for the LECs were the same as those for the U.S. economy. Rather, it was demonstrated in the course of the initial price cap proceeding that, over a long time period, the input price difference was zero.[76] Based on this conclusion, the Commission adopted the formula for determining the productivity factor as the difference between the productivity for the telecommunications industry and the productivity of the U.S. economy.

Recent studies have confirmed this conclusion. For example, the NERA Study submitted with NYNEX's comments noted that there was essentially no difference between the input prices for the telecommunications industry and the U.S. economy for the period 1951 through 1987.[77]

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75 ETI Study at p. 56.

76 See Study by Dr. L. R. Christensen in Appendix F of AT&T's Comments dated October 9, 1987 in response to the Commission's Notice of Proposed Rulemaking in CC Docket 87-313. According to Dr. Christensen's calculations, input cost inflation for the Bell System and for the total U.S. private domestic economy each averaged 4.5% for the years 1948 through 1979.

77 See NERA, "Economic Performance of the Price Cap Plan", May 9, 1994 at pp. 14-15. ("NERA Study"). An input price

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The contention by some parties that the Commission should adopt the productivity offsets used in various intrastate price cap plans is also without merit.[78] There is no logical connection between "inflation offsets" in state-specific incentive regulation plans and the productivity offset in the Commission's price cap plan. As the Commission observed in rejecting similar arguments in the initial price cap proceeding:

> Several states have adopted productivity offsets in conjunction with incentive based regulatory plans.... We do not believe that the designation of a 4.5 percent productivity offset factor for intrastate services in California should bear significantly on our selection of a productivity offset to be used in a federal price cap plan for interstate access since the plans differ in significant respects. Just as the productivity of one operating company cannot be assumed to apply to an entire segment of the telecommunications industry, the productivity offset for California cannot be assumed to apply to the Nation as a whole.[79]

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77 (Footnote Continued From Previous Page)

index for the U.S. economy was constructed using the Bureau of Labor Statistics multifactor productivity growth estimates for U.S. private business and the GNP-PI measure of national output price changes for 1951-1987. This was compared to input prices for the telecommunications industry based on a TFP study by Dr. L. R. Christensen.

78 See POCA at p. 7. ("It would be appropriate for the FCC to increase the inflation offset consistent with recent data reviewed by the PaOCA and used by the administrative law judges in Pennsylvania and California.")

79 Policy and Rules Concerning Rates For Dominant Carriers, Supplemental Notice of Proposed Rulemaking, CC Docket No. 87-313, 5 FCC Rcd 2176, 2228 n.191 (1990).

In general, productivity offsets in state plans are not directly comparable with each other or with the productivity offset contained in the Commission's plan, because of differences in the structure of the plans and the mix of services covered by the plans. Finally, differences in cost structure and historical productivity growth make it impossible to use a localized productivity factor on a national basis.

MCI claims that the Commission erred in including the 1984 data point in its original calculation of the productivity offset, and that a productivity factor of 5.9 is warranted. MCI's argument has already been considered and rejected by the Commission. In the initial price cap proceeding, the Commission rejected AT&T's contention that the 1984 data point should be disregarded. The Commission stated, "[w]e are not convinced that the data available from [the 1984/85 period] is so unreliable as to be completely discounted."[80] While recognizing that the events in the telecommunications industry in 1984 were unusual, the Commission nonetheless decided to use data from that year, stating that:

> However, the effect of these changes can be evaluated and removed from the analysis in a manner that provides a more accurate picture of LEC productivity than if data from those years were omitted altogether. This is a technique common to all indirect price studies, including the ones performed by AT&T to determine LEC productivity.[81]

MCI has produced no new support for its position. Its arguments should therefore be rejected.

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80 Id. at p. 45.

81 Id. at p. 44.

Ad Hoc argues that the productivity factor should be adjusted upward to account for anticipated future productivity growth.[82] Ad Hoc fails to justify the proposed modification. There is no evidence to support the claim that telecommunications productivity growth will be relatively greater in the future. Total factor productivity for telecommunications has consistently grown approximately two percent faster than TFP for the entire U.S. economy, and there is no evidence to support the conclusion that TFP growth will be significantly different in the future. To the contrary, much of the technology from which significant LEC productivity gains could be derived has already been deployed.[83] In any event, despite the introduction of these new technologies, recent TFP studies show no increase in productivity growth in recent years.[84]

Moreover, the Commission has previously concluded that the productivity factor adopted in the price cap proceeding

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82 See Ad Hoc at p. 20 ("In telecommunications, advances such as digital switching, fiber optic transport, and advanced signalling technologies, have provided LECs with enormous opportunities for productivity enhancements, translating into cost reductions that can, and should, be passed on to business and residential customers -- reductions which would be passed on under competitive market conditions.")

83 For example, in NYNEX's region, there are approximately 964,000 strand miles of fiber optic interoffice facilities in place, while approximately 81% of central offices are digital. The proportion of subscriber lines with SS7 technology has grown to approximately 70%

84 See Christensen Associates, "Productivity of the Local Operating Companies Subject to Price Cap Regulation", April 25, 1994, Laurits R. Christensen, Philip E. Shoech, and Mark Meitzen. A copy of the study was attached as Attachment H to NYNEX's Comments in this proceeding.

reflects the technological trends which have characterized the telecommunications industry over the long term:

> [W]e do not agree with parties that contend that the Commission has overlooked significant productivity gains that will be realized through technological innovation in selecting its productivity factor.... [N]o data have been presented that refute the well established fact that the communications industry, since its inception, has been marked by technological innovation. This being the case, our productivity factor, based on the long-run historical experience of the industry, already reflects this characteristic.[85]

All the evidence in this proceeding demonstrates that telecommunications productivity relative to the U.S. economy has remained relatively constant over time. There is no basis for adjusting the productivity factor upward to account for unsupported suggestions that productivity will increase in the future.

The Commission should also reject Ad Hoc's proposal to increase the consumer productivity dividend to 1%. The only reason given by Ad Hoc for its proposal is that a "stretch component should be applied as a further offset to the GNP-PI inflation index."[86] Rather than increasing the consumer productivity dividend, it should instead be eliminated. The inclusion of a consumer productivity dividend constitutes an unnecessary departure from the investment and efficiency incentives that exist in competitive markets. Through July 1,

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85 Policy and Rules Concerning Rates for Dominant Carriers, Supplemental Notice of Proposed Rulemaking, CC Docket No. 87-313, 5 FCC Rcd 2176, 2228 (1990).

86 Ad Hoc at p. 22.

1995, consumers will have already received a "consumer dividend" of $975 million, and will continue to receive an annual dividend of $394 million from the embedded current rates.[87] As Professor Harris has noted, there is "no economic rationale for incorporating a 'stretch' factor in the price cap mechanism...."[88] Elimination of the consumer productivity dividend is particularly important as a matter of regulatory parity since the rules recently adopted for the LECs' cable company competitors do not include a consumer productivity dividend.

VII. THERE IS NO BASIS FOR A ONE-TIME PRICE CAP REDUCTION OR A REALIGNMENT OF THE LOW END ADJUSTMENT OR SHARING MECHANISM TO REFLECT CHANGES IN CAPITAL COSTS

Several parties assert that LECs' capital costs have declined since the beginning of price cap regulation,[89] and that the Commission should therefore order a one-time price cap reduction and/or a realignment of the sharing mechanism.[90] These arguments are without merit and should be rejected by the Commission.

These parties' cost of capital presentations are fundamentally flawed. The more credible evidence in this proceeding demonstrates that the Commission's currently prescribed interstate access rate of return of 11.25% is below,

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87 Harris Reply Report at p. 2.

88 Harris Report at p. 25.

89 AT&T, Ad Hoc, ARINC, CCTA, GSA, MCI, OCCO.

90 AT&T, MCI, OCCO.

rather than above, a zone of reasonable cost of capital estimates. Moreover, other factors, including the need to stimulate infrastructure investment, support a rate of return from the upward part of such a range.[91]

Even if the Commission were to perceive that the 11.25% rate of return does not reflect cost of capital, a one-time price cap reduction and realignment of the low end adjustment/sharing mechanism would be wholly improper. The NPRM did not provide notice of such action and, given the complex issues, a further proceeding based upon a suitable record would be required. Since the 11.25% rate of return and low end adjustment/sharing mechanism parameters were prescribed by the Commission under Section 205 of the Communications Act,[92] there can be no retrospective change of those prescriptions.

Furthermore, a cost of capital change should not be given exogenous treatment under price cap regulation because (i) capital cost or rate of return prescription changes are not on the Commission's list of items eligible for exogenous treatment; (ii) such changes are similar to changes in other factor costs which are given endogenous treatment, e.g. represcription of depreciation rates; (iii) exogenous treatment of capital cost changes would double-count to an undetermined

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91 This is not a rate of return represcription proceeding. NYNEX is submitting this evidence simply to avoid the claim that its silence on the issue should be viewed as acquiescence in the fallacious claims of AT&T, MCI and others.

92 47 U.S.C. Section 205.

degree, changes captured in the GNP-PI element of the price cap formula; and (iv) exogenous treatment of rate of return would severely undermine the incentive basis of price cap regulation. Even if rate of return were to be treated exogenously, the most current capital cost data will need to be utilized, as opposed to the stale historical data presented by those parties who suggest that re-examination of the rate of return is appropriate.

1. The Cost Of Capital Analyses Presented By AT&T And MCI Are Fundamentally Flawed

MCI suggests that the LECs' cost of capital has decreased such that the authorized interstate rate of return should be reduced by 171 basis points.[93] On this basis, MCI argues for a one-time reduction in price cap indices and for a recalibration of the sharing mechanism centered around its proposed rate of return. More specifically, employing a Discounted Cash Flow ("DCF") approach, MCI's consultant Matthew Kahal "finds" a cost of equity for the Regional Bell Holding Companies ("RHCs") of 11% as of March 1994.[94] Based on these cost of capital estimates, Mr. Kahal recommends a 9.54% interstate rate of return for price cap LECs. Similarly, AT&T submits a DCF study purporting to show that for 1991-93, the

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93 See Statement of Matthew I. Kahal, "Concerning: Cost of Capital", May 1994, attached to comments of MCI.

94 Mr. Kahal uses RHC capital structures and embedded costs of debt as of December 31, 1993.

cost of capital for price cap LECs was 9.93%, a 132 basis point drop from the 11.25% authorized interstate rate of return.[95]

The Billingsley Report submitted by USTA with its reply comments demonstrates that MCI and AT&T have grossly understated the cost of capital for price cap LECs.[96] Dr. Billingsley shows that, in estimating the LECs' overall cost of capital Mr. Kahal (i) misunderstood the nature and capital market effects of the increase in competition facing LECs since 1990; (ii) improperly relied on the RHCs as comparable in risk to the LECs in applying the DCF model to estimate cost of equity, and in determining capital structure; and (iii) used improper inputs to the DCF model.[97] One of Mr. Kahal's most significant errors is his assumption that, although competition has increased, this was fully anticipated by the capital markets and thus the trend has not changed LEC overall cost of capital since 1990. As indicated by Dr. Billingsley, there is no evidence that the investment community has been able, now or ever, to fully anticipate the specific nature and extent of the implications of increasing competition in the LECs' business.[98]

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95 The other parties alleging LEC cost of capital reductions merely point to declines in interest rates over certain past periods. See Ad Hoc, ARINC, GSA, CCTA.

96 Report of Dr. Randall S. Billingsley, dated June 1994 ("Billingsley Report").

97 Billingsley Report at p. 9.

98 Id. at pp. 9-10.

Dr. Billingsley also demonstrates that AT&T's arguments are without merit.[99] AT&T does not estimate a current cost of capital for LECs reflecting up-to-date market conditions, but merely performs an historical calculation of the LECs' cost of capital using an incorrect form of the DCF model to estimate the cost of equity. AT&T compounds its errors by misapplying that model to RHCs as a surrogate for LECs, and by using RHC capital structures.[100] AT&T mistakenly concludes, "LECs' cost of capital has averaged no higher than 9.93 percent over the period 1991-93 -- some 132 basis points lower than those carriers' current reference rate of return."[101] AT&T's flawed historical analysis is simply irrelevant to assessing the LECs' current cost of capital.

Dr. Billingsley further demonstrates that the reliance by MCI, AT&T and other parties on declining interest rates since 1990 is woefully misplaced. Those parties who contend that a reduction in the cost of capital is warranted in light of declining interest rates simply ignore the fact that interest rates are just one of many factors to consider in estimating cost of capital. They further ignore the fact that the LECs' business risk, as perceived by the investment community, has increased significantly. That increased business risk reflects the dramatic increase in competition in

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99 Id. at pp. 15-17.

100 See also Dr. Billingsley's rebuttal of MCI in this area.

101 AT&T at p. 31.

the telecommunications industry. Moreover, to the extent that interest rates impact the LECs cost of capital, there are recent signs of an upward trend of interest rates.[102]

2. When Properly Calculated The LECs' Cost Of Capital Is In The Range Of 11.64%-11.82%

The currently authorized 11.25% rate of return is below the zone of reasonableness. Using the most recent evidence available, Dr. Billingsley estimates the average cost of capital for LECs by estimating the average cost of capital for BOCs using two distinct but complementary approaches. Each employs an average capital structure of 40.97% debt and 59.03% equity, and an average cost of debt for LECs of 7.88%. The first approach, which utilizes a comparable firm group and the DCF method of estimating cost of equity, provides an objective, market-determined cost of equity capital for LECs. That approach indicates the average cost of equity for LECs is 14.25%-14.33%.[103] The second approach used by Dr. Billingsley - the risk premium method - includes evidence on changes in risk premiums resulting from variations in the level of interest rates. That approach indicates an average cost of equity for LECs of 14.32%-14.56%.[104]

The two methods employed by Dr. Billingsley thus demonstrate that the cost of equity for LECs is within the

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102 This trend is acknowledged by MCI (see Statement by Mr. Kahal at p. 10).

103 Billingsley Report, Exhibit RSB-1 at p. 5.

104 Id. at p. 9.

range 14.25%-14.56%, with a midpoint of 14.41%. This exceeds the 12.5%-13.5% cost of equity range found to be reasonable by the Commission in 1990.[105]

Moreover, based on his analysis of the LECs' cost of debt, cost of equity, and capital structure, Dr. Billingsley concludes that the current overall cost of capital for LECs is within the range 11.64%-11.82%, with a midpoint of 11.73%.[106] This current cost of capital is higher than the Commission-prescribed 11.25% rate of return, which was selected by the Commission from a cost of capital range of 10.85%-11.40%.[107]

Finally, Dr. Billingsley addresses the decline in interest rates in recent years, a development cited in the Commission's NPRM.[108] Dr. Billingsley's methods of estimating LEC capital costs take into account the decline in interest rates. The cost of debt and capital structure used in his analyses are based upon the most up-to-date data available, which reflect the effects of recent interest rate movements. Further, the DCF model uses market-determined stock prices and growth rate forecasts that are determined by investors in light of, among other things, current and expected interest rates. Also, the market risk premium approach adjusts explicitly for

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105 See Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, 5 FCC Rcd 7507 (1990) ("Rate of Return Order"), at para. 9.

106 Billingsley Report, Exhibit RSB-1 at p. 12.

107 Rate of Return Order at para. 12.

108 NPRM at paras. 44, 54.